BEFORE

THE PUBLIC SERVICE COMMISSION OF

SOUTH CAROLINA

DOCKET NO. 95-862-C - ORDER NO. 96-75

FEBRUARY 12, 1996

IN RE: BellSouth Telecommunications, Inc. DBA Southern Bell Telephone and Telegraph Company - Investigation of Level of Earnings.	))))	ORDER DENYING PETITIONS

I. Introduction

This matter comes before the Public Service Commission of South Carolina (the Commission) on various Petitions for Rehearing and Reconsideration filed with regard to our Order No. 95-1757 in this Docket. Petitions were filed by the Consumer Advocate for the State of South Carolina (the Consumer Advocate), BellSouth Telecommunications, Inc. (BellSouth), AT&T Communications of the Southern States, Inc. (AT&T), MCI Telecommunications Corporation (MCI), and the South Carolina Public Communications Association (SCPCA). Subsequent to the issuance of Order No. 95-1757, this Commission issued Order No. 96-43, approving various tariffs filed, pursuant to Order No. 95-1757. The Consumer Advocate, MCI and SCPCA also filed Petitions for Rehearing and/or Reconsideration concerning this Order. Our intention in the present Order is to rule on all mentioned Petitions for Rehearing and/or Reconsideration as noted above. For the reasons stated hereinafter, all Petitions are hereby denied.

II. Return on Equity

Both the Consumer Advocate and BellSouth have petitioned for rehearing and reconsideration with regard to the Commission's holding on the appropriate rate of return on equity. The Consumer Advocate states that in Order No. 95-1757, the Commission specifically found that the proper surrogates to be used in estimating the cost of common equity for BellSouth are telecommunications companies. See Order No. 95-1757 at 37. The Consumer Advocate states that, given this, it is incumbent upon the Commission to approve a cost of common equity which falls within the recommended ranges of the two witnesses who did a complete analysis using telecommunications companies, namely Dr. Legler and Dr. Spearman. According to the Consumer Advocate, this would require setting a return on equity somewhere between Dr. Legler's low of 10.4%, and Dr. Spearman's high of 12%, rather than the 12.75% rate of return on equity granted by the Commission.

The Commission has examined this matter and has determined that the following sentence in Order No. 95-1757 shall hereby be reconsidered and withdrawn. "We disagree with Dr. Billingsley's assertions that Dr. Legler's and Dr. Spearman's surrogates are inappropriate, and hold, in this case, that telecommunications companies are a better comparison group with BellSouth than the various non-utility surrogates favored by Dr. Billingsley." Order No. 95-1757 at 37. Therefore, the 12.75% held to be appropriate by this Commission in Order No. 95-1757 fits appropriately between the low end of the range as delineated by Dr. Legler at 10.40%,

and the high end as delineated in Dr. Billingsley's direct testimony of 13.95%. Thus, the Consumer Advocate's allegation is without merit.

The Consumer Advocate also states that the Commission has placed reliance on the rebuttal testimony of Dr. Billingsley in approving the return of 12.75%. The Consumer Advocate goes on to state that Dr. Billingsley's rework of Dr. Legler's methodology is of no probative value. This assertion is without merit. The Commission merely mentions the top of the range contained in Dr. Billingsley's rebuttal testimony. The Commission did not adopt Dr. Billingsley's rebuttal testimony as a basis for its final holding, but merely mentioned it as a part of the evidence that had been submitted. We see no reason to change the rate of return on equity holding, pursuant to the Consumer Advocate's assertions.

BellSouth also states that the rate of return on equity approved by the Commission is inappropriate, in this case, stating that it is too low. The Commission notes that the testimony of Dr. Billingsley supports a cost of equity capital within the range of 13.71% to 13.95%, with a midpoint of 13.83%. The Commission explained fully in Order No. 95-1757 why it held that a rate of return on equity somewhat lower than Dr. Billingsley's range was appropriate. We explained, among other things, that the value of 12.75% represents a reasonable expectation for the equity owner, and is therefore consistent with the standards in the Hope decision. Further, the testimony of two witnesses other than Dr. Billingsley recommended a rate of return somewhat lower than Dr.

Billingsley, as mentioned above.

In our Order No. 95-1757, we found the testimony of all witnesses credible, however, we found specific points in each of the testimonies that we simply did not agree with. The Commission therefore arrived at a rate of return on equity of 12.75% as the appropriate cost of equity as one meeting the reasonable expectation of the equity owner and falling within the range of rate of returns stated by all of the witnesses. The assertion of BellSouth that the Commission's adopted rate of return on equity is too low is therefore without merit.

III. Area Plus

The Consumer Advocate, AT&T, MCI, and the SCPCA challenged the decision of the Commission regarding BellSouth's Area Plus adjustment. These parties all assert that the approved adjustment violates the Stipulation signed by BellSouth on April 11, 1994 (Docket No. 93-176-C). The Commission finds no error in its decision regarding Area Plus in Order No. 95-1757. The Stipulation concerned provides in pertinent part:

> BellSouth will not come before this Commission requesting rate relief for any possible losses resulting from the introduction of Area Plus service, the execution of the Area Calling Plan Principles Agreement, or this Stipulation.

As stated in Order No. 95-1757, BellSouth has not requested rate relief. BellSouth did not petition this Commission for review or relief. The Commission ordered the opening of this docket to investigate the earnings of BellSouth in 1994. BellSouth submitted its adjustment in response to the investigation, and such action

did not constitute a violation of the Stipulation. Staff calculated its adjustment in furtherance of the investigation, and the Commission adopted Staff's adjustment, and not the adjustment proposed by BellSouth.

Adjustments are made to recognize all known and measurable changes in order to reflect the financial status of a company. In the instant case, the Commission deemed the adjustment as being based on known and measurable data which recognized the demand for the Area Plus service.

The data used to calculate the adjustment was, in fact, actual. BellSouth provided to Staff actual data produced by analysis of the changes in the toll revenue accounts versus the Area Plus revenue accounts. When compared, these accounts and the data derived from the analysis measured the impact of Area Plus. In other words, the adjustment is the net effect of increased local revenues offset by the loss of toll revenue. Customers' usage volumes were factored into the analysis. In calculation of the customer usage portion of the data, the Company did have to make certain assumptions based on a sample of BellSouth customers and their calling habits. These assumptions of customer usage were based on actual usage of a sample of BellSouth Area Plus customers. The data may be referred to as "estimated" only in the sense that every single call of every particular customer in all of BellSouth's territory was not tracked and priced. The assumptions were derived no differently than much data used to calculate various adjustments.

This adjustment was made as any other adjustment: known and measurable data was utilized to calculate a figure, and the figure was projected forth to represent the year's revenues relating to Area Plus. Staff used the most recent data of January - June, 1995, to produce its adjustment. The Commission chose Staff's adjustment since it was more accurate than the Company's proposed annualized figure of one month's losses.

As Company witness Reid states, "The Area Plus Plan impacts represent a steadily increasing reduction in the Company's revenues as customers avail themselves of this option." Tr. Vol. 4, Reid at 222. Therefore, the Commission's adjustment for Area Plus losses was most appropriate and reasonable under the circumstances.

IV. Accounting Adjustments

The Consumer Advocate and BellSouth petition for reconsideration and/or rehearing of various accounting adjustments approved by this Commission in Order No. 95-1757.

The Consumer Advocate contests the Commission's decision regarding BellCore dividends and investment. The Consumer Advocate states that the Order fails to make findings of fact, simply recites conflicting positions of the parties, and was based on the notion that it is consistent with Order No. 87-466, all of which the Consumer Advocate declares are error on the part of the Commission. Further, the Consumer Advocate believes that BellCore adjustments should be eliminated, since it was once a part of BellSouth Services, Inc. (BSS), which no longer exists. The Commission disagrees with these statements, and would state the

following with regard to BellCore dividends. As part of BellSouth's co-ownership of BellCore, it receives work programs, and such items as marketing, information systems support, technical training, network services, and other support functions. If these services were not performed by BellCore, then BellSouth would have to obtain them in some other manner. Although BellCore was once part of BellSouth Services, Inc., it now operates on its own. This Commission believes, based on the evidence, that the ratepayer is still entitled to the dividends from BellCore, and should be given that benefit which Staff's adjustment does as adopted by this Commission in Order No. 95-1757.

Additionally, BellCore has certain investments necessary to render the above-stated services to the Company. Therefore, inclusion of the Company's investment in BellCore in rate base is appropriate. We therefore supplement our Order No. 95-1757 with the information as stated above, and further explanation of our holding on BellCore dividends and interest. Although we recognized the precedent of Order No. 87-466 issued in Docket No. 87-77-C, it was not the sole basis for our holding. We reject the Consumer Advocate's challenge to this adjustment as adopted.

Next, the Consumer Advocate states that the Commission's decision regarding net write-offs of uncollectibles should be clarified. According to the Consumer Advocate, the position attributed to the Consumer Advocate was not his final position on this issue. We have examined the Consumer Advocate's assertion, and agree that the position as stated in Order No. 95-1757 was

withdrawn at the hearing. However, the Commission reasserts its position as stated in Order No. 95-1757 that the Staff's treatment of this item is appropriate, and follows proper accounting and regulatory procedures, and since the matter is therefore unchallenged, the Commission reasserts its adoption of Staff's adjustment on this item.

The Consumer Advocate takes issue with the Commission's holding regarding the effect of the operations of BellSouth Advertising and Publishing Company (BAPCO) on BellSouth's revenues. The Consumer Advocate states that the Commission's holding fails to make findings of fact supported by evidence of record, simply recites conflicting positions, and is arbitrary, capricious, etc. The Consumer Advocate also states that the evidence of record clearly showed that the non-recurring accounting adjustments, which were made in December 1994, resulted in an abnormally low income figure. The Consumer Advocate further notes that the Commission should have adjusted the BAPCO income level in order to normalize the test year, based on the significantly different figure appearing during the test year.

Upon examination, the Consumer Advocate's proposal to adjust BAPCO income is based on the assumption that certain BAPCO accounting adjustments are non-recurring in nature. This is pure speculation. Further, BAPCO's entire South Carolina revenues are included in Staff's adjustment, and therefore, in accordance with the matching concept, all of the expenses included in the year should be allowed for ratemaking purposes. Staff's adjustment met

these criteria. The Commission therefore believes it was correct in adopting Staff's adjustment, and reiterates that it was the most accurate adjustment, and that it relied upon known and measurable data.

With regard to environmental cleanup costs, the Consumer Advocate complains, among other things, that the Commission's decision was based on the fact that it complies with Order No. 94-1229, issued in Docket No. 93-503-C. The Consumer Advocate then opines that the previously existing practice may not be substituted for an evaluation of the evidence, and that a previously adopted policy may not furnish the sole basis for a Commission finding. He also asserts that we should have adopted an adjustment which reconciled actual liability with costs which have been recovered through rates. The Consumer Advocate admits the fact that the Commission's adopted adjustment in Order No. 95-1757 is based on the liability established in Docket No. 93-503-C which was to be amortized over a five (5) year period. The adjustment in the present case was clearly consistent with that holding.

Further, environmental cleanup costs are an individual expense item based on the best known and measurable data at the time at which rates are set. The Commission does not isolate each and every expense item to determine in regard to such expense whether there has been an over or under recovery. The Commission set rates previously based on the best known and measurable data at the time, and to return to such data now to reward or penalize the Company for over or under recovery constitutes illegal retroactive

ratemaking. Thus, the Consumer Advocate's position is inappropriate. The Commission's adopted position as shown in Order No. 95-1757 is therefore appropriate, and is reaffirmed.

With regard to annualization of salary and wages expenses, the Consumer Advocate complains that, among other things, the Commission adopted an adjustment not based on the latest available known data. The Staff adjustment was developed based upon a three (3) month period of March through May 1995. Subsequent to the Staff's audit, some information apparently became available to the Consumer Advocate for the month of June 1995. Staff audited the March through May 1995 data, and used such data in its adjustment. Staff could not verify the accuracy of the June data, because it was not available at the time of Staff's audit. The Commission uses audited data when available, rather than unaudited information such as data from June 1995. Therefore, we believe that our prior holding on annualization of salaries and wages was appropriate and proper.

Both the Consumer Advocate and BellSouth request rehearing and reconsideration regarding reorganization costs and consultant fees. The Consumer Advocates states that utilizing a two-year amortization period for reorganization costs, and a three-year period for consultant fees fails to balance the interests of current ratepayers versus future ratepayers. In effect, according to the Consumer Advocate, current ratepayers are being penalized twice. They must bear the costs of reorganization over only a two-year period, and cannot take advantage of the further cost

reductions due to down-sizing that have occurred since June 1995. Further, the Consumer Advocate criticizes the amortization period chosen by the Commission.

Amortization periods fall within the discretion of the Commission. It is within the Commission's purview to set varying amortization periods and to choose to help the Company prepare for the movement towards deregulation. The method adopted by the Commission does not rob the ratepayer of future cost reductions, since wages are already decreased in this case as a result of the Company's reorganization efforts. A three year amortization period of reorganization costs and consultant fees balances, in our opinion, the burden between the consumers and the shareholders. Therefore, the Consumer Advocate's concerns are without merit.

BellSouth also states that the Commission's reorganization cost holding was inappropriate. BellSouth states that the testimony established that, due to the evidence of competition, deferring expenses which would otherwise be recovered in the current period by competitive firms is impractical, and therefore an amortization period is inappropriate.

Reorganization costs will benefit more than one period and should be amortized to normalize the test year. Reorganization costs and consultant fees were incurred to prepare the Company for the environment in which the Company will operate in future years. Therefore, amortization into future years is still appropriate under the present regulatory scheme.

Next, the Consumer Advocate criticizes the Commission's

decision on customer growth. The Consumer Advocate's proposed adjustment simply constitutes an inconsistent use of the customer growth formula, since it compared a certain amount of access lines to the average growth, as opposed to the actual growth percentage for the test year. We felt that the Staff's methodology was more appropriate under the circumstances, since it employed an actual growth percentage. Therefore, the Consumer Advocate's criticism is without merit, and we reaffirm our adoption of the Staff adjustment.

The Consumer Advocate further contests the Commission decision regarding the sale of BellBoy Paging Service. The Consumer Advocate states that the Commission's conclusion that an adjustment for the higher figure proposed by the Consumer Advocate is "simply unnecessary" is not a finding of fact supported by the evidence of record. The Consumer Advocate also states that the Commission is incorrect in its conclusion that the Staff-Company adjustment only eliminates Account 7370 costs. Further, the Consumer Advocate complains that the Commission failed to follow its own precedent. The difference in the Consumer Advocate's approach and the Staff-Company position is due to the gain on the sale of BellBoy, which the Consumer Advocate has recommended be included as an offset to cost of service. It should be noted that the Commission's treatment in this case is in accordance with the Federal Communications Commission Chart of Accounts. Further, the gain on the sale is non-recurring in nature and should be eliminated, in accordance with good accounting principles. The

Commission's holding in Order No. 95-1757 is therefore correct and reasonable under the circumstances.

Both the Consumer Advocate and BellSouth take issue with the Commission's decision regarding refinancing costs. The Consumer Advocate alleges that there is no evidence in the record to support the conclusion that Staff's method does not allow BellSouth to over-recover its costs. It should be noted that the Staff's method does not allow over-recovery, because it does not place any amortization expense above the line for ratemaking purposes. It is necessary to adjust cost of debt, because the Company incurs amortization of refinancing cost, in addition to interest expense on the new debt issues annually. The Company must invest in refinancing costs in order to obtain lower cost debt. The benefits of this lower cost debt are reflected in cost of debt calculations. To not allow return on the up-front costs (unamortized refinancing debt costs) would dissuade the Company from refinancing or force the Company to forego a return on its investment in refinancing costs. The Commission chose the Staff's method in lieu of allowing an above the line expense component for refinancing costs. The annual amortization amount varies depending on which year it is since some of the new debt was issued over varying periods. (The South Carolina amount was shown to be approximately $950,000 annually over the next several years.) The Staff methodology was appropriate.

BellSouth also takes issue with the refinancing costs holding of the Commission, and states that Commission's conclusion is

inconsistent with the stated policy of encouraging BellSouth to lower its cost of debt. We believe that the method encourages the Company to refinance by allowing recovery through the embedded cost of debt calculations, rather than above the line as a direct expense item. Staff's method also encourages the Company to refinance by allowing the Company to earn a return on its unamortized refinancing costs. This increases the Company's rate base. The method which allows no recovery at all was previously used by this Commission in Southern Bell Docket No. 90-626-C, Order No. 91-595. The Commission changed to the Staff's present method to encourage the Company to take advantage of lower interest rates. The Staff's method in this case promotes a sharing of the costs between the ratepayer and the shareholder by not allowing direct above the line treatment.

Finally, the Consumer Advocate alleges that the Commission's decision regarding cash working capital allowance is arbitrary. The Consumer Advocate alleges that the record in this case does not contain any support for use of a formula method. We agree. The Commission notes that the formula method was not adopted in the present case. The formula method is not appropriate for BellSouth because of the amount of advance billings done by the Company. Instead, the Commission adopted the average daily cash balance method. The average daily cash balance method has been used historically by the Commission as a true and accurate measure of cash working capital requirements for BellSouth. We believe the methodology is appropriate in this case and is more appropriate

than the lead lag method proposed by the Consumer Advocate. There is no such thing as a negative cash working capital requirement, since companies must have cash on hand to operate. Staff's method in this case recognizes that the Company has set aside daily cash balances for the day to day operations of the Company. The Commission considers this to be an investment made by the shareholders upon which they are entitled to earn a return. We believe that the average cash balance method is better than lead lag because the lead lag method penalizes good cash management and rewards the inefficient manager of cash.

We note that, for some accounting adjustments, the Consumer Advocate alleges that the Commission failed to follow its own precedent, and, for other accounting adjustments, that the Commission employed a previously adopted policy as the sole basis for a Commission finding. We find these positions to be inconsistent. However, we believe that we have adequately explained our findings and reasoning in those instances where we did not follow prior Commission rulings, and the circumstances of the present case were thoroughly analyzed before policies emanating from a prior case were applied. It is clear that as long as the evidence in the present case is weighed by the Commission, the Commission is free to apply long-standing regulatory principles from prior cases which apply to present cases. The Consumer Advocate's allegations are without merit.

Also, we note that the Consumer Advocate mentions several times in its Petition that the Commission's Order does not contain

sufficient findings of fact and quotes Able Communications, Inc. v. South Carolina Public Service Commission, 290 S.C. 409, 351 S.E.2d 151 (1986) to support its opinion. Able states that specific, express findings of fact must be made, but that no particular format is required. We believe that the reasons underlying our decisions were clearly set forth which is all that is required by Able. This allegation is also without substance.

BellSouth also challenges the appropriateness of the Commission's holding as to capital FAS 106 costs. We believe that our holding in Order No. 95-1757 is fully explanatory in this case. We believe that it is hard to argue that discount rates are going even lower than during the test period, when the data used is based on the lowest rates in a twenty (20) year period. The assertion of BellSouth that the discount rates are going even lower is pure speculation. Future changes to discount rates are not known and measurable at this time. Therefore, the Commission's holding in Order No. 95-1757, based on known and measurable data, is appropriate, and BellSouth's assertion is without merit.

BellSouth also criticizes the Commission's calculation of the amount of rate reduction in Order No. 95-1757, based on the above-captioned allegedly erroneous holdings. For the reasons stated above, we think that our Commission's holdings on the various accounting adjustments were correct, and therefore, its calculation of the $42,262,763 rate reduction was appropriate, based on those holdings.

V. Other Issues

AT&T and MCI take issue with the Commission Order requiring them to provide a plan for flowthrough of reduced access charges that come about as a result of the rate reductions in Order No. 95-1757. We believe that such a plan is only appropriate to ensure that consumers will receive the full benefit of access charge reductions. The Commission is charged with the examination of all rate matters in the telecommunications industry in this State, and believes that it is entitled to supervise matters which should bring cost savings to the State's consumers. Therefore, AT&T's and MCI's assertions notwithstanding, the Order ordering the filing of a flowthrough plan was completely appropriate, and necessary to monitor monies that should be made available to all consumers.

SCPCA petitions for Reconsideration stating that the Commission failed to reduce PTAS charges to it. The Commission notes that the manner in which rates should be reduced is a matter totally within the discretion of the Commission. The Commission notes that business rates were reduced in several particulars under Order No. 95-1757, and that rates for pay telephone providers are based on those business rates. Therefore, the pay telephone industry received the benefit of the business rate reductions ordered by the Commission. Accordingly, the Commission holds that the SCPCA Petition for Reconsideration on this matter is without merit.

It should also be noted that the Consumer Advocate, MCI and SCPCA petitioned for Reconsideration and/or Rehearing of our Order

No. 96-43, which approved tariffs based on the Commission's holdings in Order No. 95-1757. For the reasons stated above, we hold that these Petitions are without merit, in that our tariff Order was appropriate, and that the Petitions as to Order No. 96-43 should also be denied, consistent with our holdings as stated above.

This Order shall remain in full force and effect until further Order of the Commission.

BY ORDER OF THE COMMISSION:

Randolph Mitchell

Chairman

ATTEST:

Executive Director

(SEAL)

Commissioner Warren D. Arthur, IV, dissenting:

I respectfully stand by my dissent in Order No. 95-1757. I believe that the 12.75% return on equity granted by the majority is clearly excessive given the downward trend in long-term interest rates over the last year. As stated in my prior dissent, long-term interest rates have declined by approximately 200 basis points since the Commission approved a 13.00% return on equity for Southern Bell in Order No. 94-1229, dated December 5, 1994, in Docket No. 93-503-C. Lowering the return on equity by only 25 basis points to 12.75% essentially ignores the market trend in

long-term interest rates.

I also disagree with the majority altering Order No. 95-1757 by eliminating the following sentence: "We disagree with Dr. Billingsley's assertions that Dr. Legler's and Dr. Spearman's surrogates are inappropriate, and hold, in this case, that telecommunications companies are a better comparison group with BellSouth than the various non-utility surrogates favored by Dr. Billingsley." Order No. 95-1757 at p. 37. As I stated in my dissent to Order No. 95-1757, I believe that more deference should have been given to the testimony of Dr. Spearman and Dr. Legler in this case. Dr. Spearman and Dr. Legler both used proxy groups comprised of telecommunications firms while Dr. Billingsley's proxy group contained non-utility surrogates. I believe that other telecommunications companies, such as the proxy companies used by Dr. Spearman and Dr. Legler, are better comparisons to BellSouth than the non-utility companies utilized by Dr. Billingsley. I disagree with the Commission for removing this sentence from Order 95-1757 because I believe that the non-utility surrogates utilized by Dr. Billingsley did not provide a comparable measure of risk for a telecommunications company such as BellSouth.

Respectfully submitted,

Warren D. Arthur, IV
Commissioner, Sixth District